AUGUST 2002

US OUTLOOK

Overview

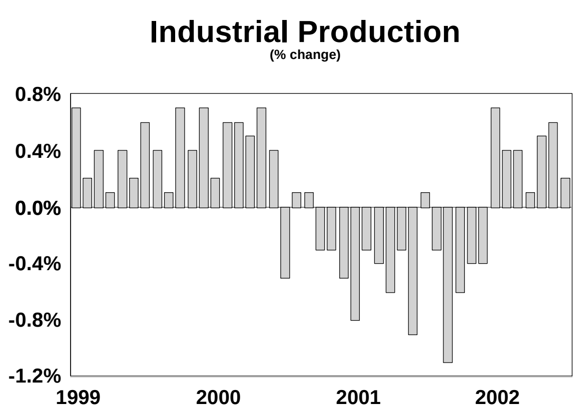
Last month's revisions to GDP figures confirm that the while the recession was shallow compared to previous recessions it was deeper and than previously thought. The economy shrank in each of the first three quarters of 2001 and most of the negative growth occurred before September 11. So far, the recovery more closely resembles the lackluster one that followed the 1990-91 recession than the booms that followed earlier downturns.

A recent spate of weak data have some fearing a return to negative growth. While that scenario is plausible it is still unlikely. The consensus among *Blue Chip* economists is that the economy will grow at a 2.8 percent rate in the second half. Given the reductions that have already occurred in business investment and inventories, a recession would require a major drop in consumer spending that is not yet in the cards given strong growth in disposable income, continued home price appreciation, mortgage refinancing, and productivity growth.

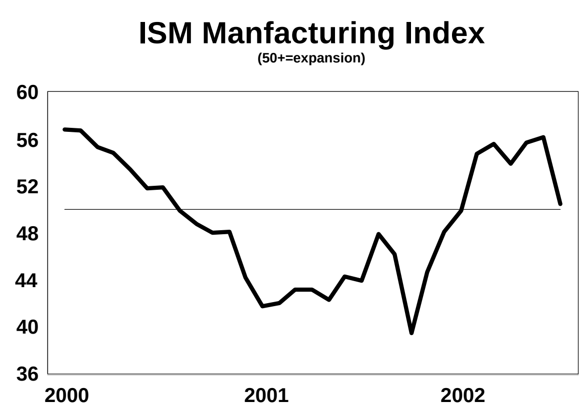
Economic Growth

The economy is recovering, but slowly. Real GDP increased at a 3 percent rate in the first half of 2002. This is better than the 1.6 rate in the two quarters after the 1990-91 recession but much slower than the 6.8, 5.3, and 7.2 rates that followed the 1970, 1973-75, and 1981-82 recessions. The recent recession was notable for the resilience of personal consumption and the housing sector. In past recessions, these usually fell much more and then snapped back in the early stages of recoveries. This time, without the steep drop there won't be any major snap back.

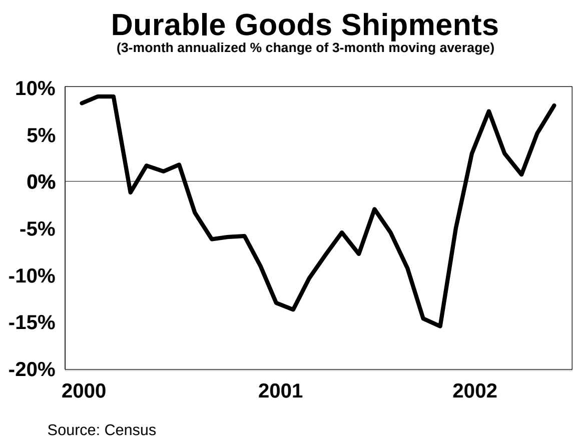
Recent data on output are mixed. Industrial production has increased every month this year, but the most recent ISM manufacturing composite index was 50.5, indicating the manufacturing sector is barely expanding, if at all. Shipments of durable goods are trending upward, but construction is trending downward.

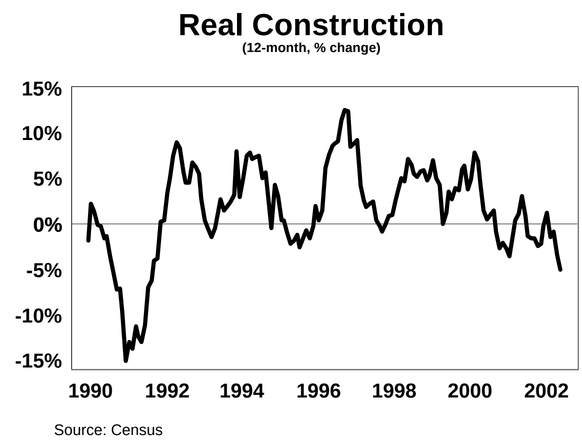


Source: Federal Reserve



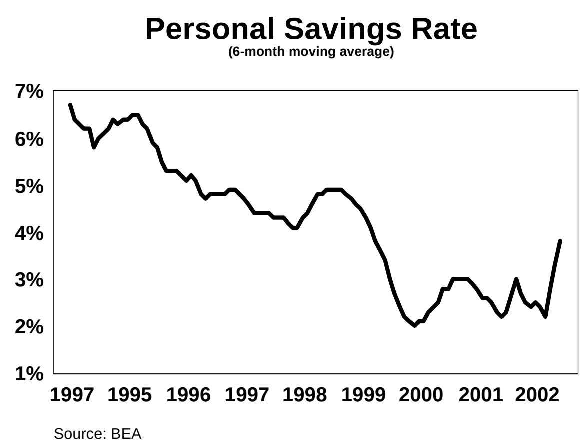
Source: National Association of Purchasing Management



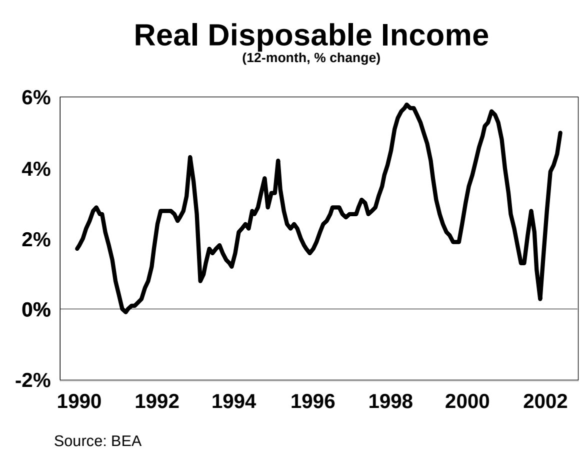


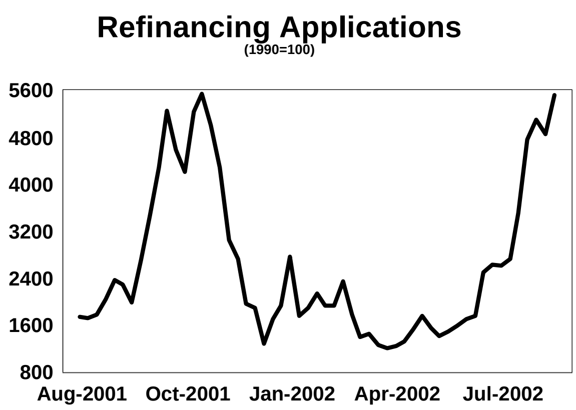
Consumption Outlook

A return to negative growth would require a major retrenchment by consumers. The $6 trillion-plus loss in stock market value since March 2000 is certainly a moderate headwind for consumption growth going forward. Consumers tend to react to lower net worth by increasing their savings, which has been happening of late.

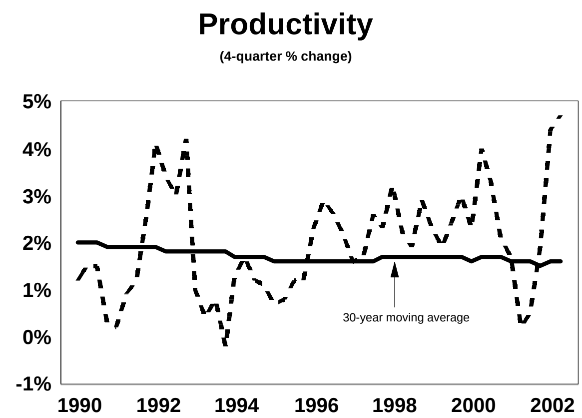


However, a number of forces are counterbalancing the decline in the stock market. Real disposable income is growing at a healthy pace, thanks in large part to tax cuts and reductions in tax payments related to the fall in the stock market. Home prices are rising. Low mortgage rates are still letting homeowners refinance to take cash out of their homes, lower monthly mortgage payments, or both. And productivity growth remains strong.





Source: Mortgage Bankers Association of America

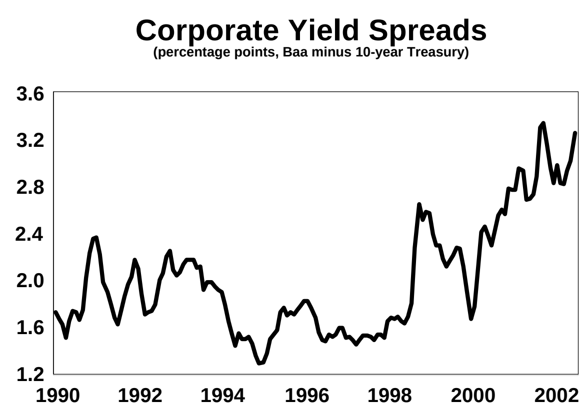


Source: BLS

This does not mean the economy is in the clear. The employment situation is far from robust. The unemployment rate is 5.9 percent and although payrolls have increased the last few months they have only risen an average of 31,000 per month. Most worrisome is the recent decline in hours worked to the lowest level since 1999. If hours worked do not recover then the gains from productivity growth will not boost consumer purchasing power as much as it otherwise could.

Business Investment

Another key factor determining the strength of economic growth going forward is the extent of the recovery in business investment. The most recent recession was largely caused by a drop in capital expenditures (i.e. capex) and inventories. Inventories have started to move upward again but capex remains a question mark. Hints at a future upswing in capex include a strong ISM new orders index and rising corporate profits. Usually business investment increases as corporate profits rise, and profits in the first quarter were up about 13 percent versus the previous year. But firms are suffering from risk aversion. The drop in the stock market has made it more expensive to raise capital by issuing equity and corporate interest rates are high compared to Treasury rates, especially for small high-risk companies. Don't expect business investment to pick up until yield spreads stop expanding.



Source: Federal Reserve

Deflation

Perhaps the biggest mystery in future months is how the economy will respond to the potential of deflation, a decline in the general price level. Capacity utilization is a solid near-term indicator of changes in the inflation rate. At present, capacity use is about 76 percent, a low level that in the past has been associated with declining inflation. But inflation does not have much room to decline. Core consumption inflation is a mere 1.6 percent.

What will happen if measured inflation falls to zero (or below) will largely depend on whether consumers and businesses expect that environment to persist. A mild bout of deflation would not be a problem as long as consumers expected it to be temporary. Witness, for example, how deals on cars and easy financing have spurred auto sales. But if consumers become confident that deflation will persist they may start to postpone purchases. Why buy now when the same car or furniture or appliance will be less expensive six months from now?

Expectations of persistent deflation have been a major factor behind Japan's long-term stagnation. First the price of gold fell dramatically (in yen terms) in the late 1980s, then the Nikkei stock market fell starting in 1990, then Japanese real estate prices collapsed starting in the early 1990s. Although Japan's deflation has been in the low single digits, major problems in the banking system that have yet to be corrected indicate a very large amount of "pent up deflation."

The US certainly does not face the same deflationary problem as Japan. The price of gold in dollar terms never fell as much or as persistently as the yen price of gold. Our stock market is down but not as much as Japan's. Real estate prices have not collapsed. And our banking system is safe. In addition, the Federal Reserve has responded much more quickly than the Bank of Japan in the early 1990s.

Key Economic Indicators

Quarterly Indicators
(Q/Q, at annual rate)

	Q3-01	Q4-01	Q1-02	Q2-02
Real GDP Growth	-0.3	2.7	5.0	1.1
Consumption	1.5	6.0	3.1	1.9
Business Investment	-6.0	-10.9	-5.8	-1.6
Trade Deficit ($ bilions)	79.8	88.0	94.9	111.1
PCE Inflation	-0.1	0.8	1.1	2.6
Productivity Growth	2.1	7.3	8.6	1.1

Monthly Indicators

	May	Jun	Jul
Unemployment	5.8	5.9	5.9
Payroll Growth	22K	66K	6K
CPI Inflation (yr./yr.)	1.18	1.07	1.47
Retail Sales Growth (yr./yr.)	2.06	3.82	4.79
Corporate Rates (Baa)	8.09	7.95	7.90
Federal Funds Rate (Month End)	1.75	1.75	1.75
Dow (Month End)	9.9K	9.2K	8.7K